Prepared Remarks of John Smith,
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"Financial Reporting in a Changing World"

Brussels, Belgium
7 May 2009

I would like to begin by thanking Mr McCreevy and the European Commission staff for organising this timely conference and for inviting me to speak today. I am also glad to have the opportunity to take part in the panel discussion and respond to questions you may have.

As the conference title suggests, the financial crisis has changed the world. It has served as a wake-up call to policymakers, regulators and standard-setters. It has exposed critical weaknesses in business practices and financial regulation. It has challenged beliefs that we once held, rightly or wrongly, as axiomatic. We will ultimately be judged on how we respond to this crisis. The result must be a more robust system of financial regulation suitable for the reality of integrated capital markets.

The IASB is acutely aware of the attention that political leaders have given to accounting standards in recent months.

We at the IASB have been and remain committed to responding in an urgent and responsible manner.

Today, I would like to discuss:

- how we have set about doing just that and
- how I see our work proceeding over the next six months.

Of course, in doing so, I am obliged to state the normal disclaimer—the views that I am expressing here are my personal ones. They do not necessarily represent the views of the IASB.

The financial crisis has highlighted three primary lessons for accounting standard-setters.

First: The integrated nature of capital markets, combined with the mobility of capital itself, highlights the need for a commonly accepted set of accounting standards.

Second: Financial institutions, regulators and investors failed to understand adequately the risks being taken. Accounting should play an important role in assisting all parties in this regard. Accordingly, there is a need to provide additional transparency to the risks being taken by financial institutions and provide meaningful information to investors and regulators.

Third: The current accounting rules create numerous options, which reduce comparability and add unnecessary complexity. Accordingly there is an urgent need to address the accounting for financial instruments to reduce complexity, enhance comparability and relevance and provide a basis for convergence worldwide.

We at the IASB are taking actions on all of these fronts.

Towards a global set of standards, the financial crisis has emphasised the relevance of the IASB's mission. More than ever, there is a need for a single set of worldwide accounting standards. This is something that Europe recognised earlier than others. Clearly, the European Union has been a catalyst and the leader in that effort in deciding to adopt International Financial Reporting Standards (IFRSs) in 2005.

Today, more than 100 countries require or permit the use of IFRSs and major economies in Asia-Oceania (Japan), North America (Canada and Mexico) and South America (Argentina, Brazil and Chile) have set out a time line towards the full adoption of IFRSs.

As to the United States, it has created another catalyst to use IFRSs by removing the reconciliation to US GAAP for foreign filers using IFRSs. Clearly, the United States is on a path towards the adoption of IFRSs, the question is, when?

We continue to work with the FASB, and in March, at our joint meeting in London, we reaffirmed our 2011 commitment under our Memorandum of Understanding.

The completion of our joint work with the FASB will result in significant convergence with accounting standards in the United States. This will reduce the cost of transition. But will that be enough to get the United States over the line?

I believe it is in the interest of the United States to adopt IFRSs in the next five years. With Brazil, Canada, China, India, Japan and Korea committed, with the European Union already using IFRSs, the cost to the United States of failing to adopt IFRSs will be high. If it doesn't adopt, it will be the outlier and those countries already adopting and committing themselves to IFRSs will not accept a situation where the United States remains outside the system indefinitely, yet has a seat at the table.

In the meantime, we continue to work with the FASB in advancing our projects under the MoU and we continue to strive to meet our end of the bargain.

I will now turn to the financial crisis and our initiatives relating to it. The real estate bubble burst in the United States. Capital deteriorated quickly as banks started reporting huge losses on mortgage loans. That created enormous uncertainty in the market because no one knew who was holding what, and who had the bad loans. So banks stopped lending to each other. They also tightened credit to all customers. Consumers stopped buying. Corporations stopped investing. The stock markets around the world declined. Pension funds lost huge amounts of value, and many jobs were lost.

We had a financial crisis around the world. And banks didn't have enough capital.

So who and what caused this problem? The fingers started pointing in every direction.

And all of the sudden we increased our accounting vocabulary with a couple of new buzz words—procyclicality and dynamic provisioning—and that old foe, fair value accounting, resurfaced with a new life; and financial reporting and accounting standards became part of the problem

So, how much of the crisis is caused by accounting? I believe very little, if any.

The complaint - current accounting rules promote procyclicality. That part is true but I state it differently. Financial reporting provides information and people react to information. I believe that transparency and neutrality of information actually reduce uncertainty and promote stability.

To be useful to users of financial statements, financial information must be unbiased. That is the role of financial reporting.

That said, I fully recognise that the IASB has an important role to play and there are many lessons learned from the crisis. We have responded by taking an unprecedented number of steps, in a considered fashion, to the crisis. We understand we urgently need to improve many of our standards and we are taking actions to do just that. The IASB approach has been measured, rapid, and targeted at addressing the real issues raised by the crisis.

As to financial reporting, we know there continues to be uncertainty about risk and early on in the crisis we heard calls for more transparency, particularly with regard to risk and off balance sheet activities and about fair value measurement and its use. Those calls were later followed by concerns about financial stability and the calls for greater comparability— a level playing field—and reduced complexity in accounting for financial instruments.

We have responded to many of the concerns that have been identified and we are continuing to respond to all of the legitimate concerns of our constituents .

- FAIR VALUE MEASUREMENT

In response to concerns about fair value measurements in illiquid markets, we set up a panel of experts to identify best practices for estimating fair value in illiquid markets and for disclosure. We held a series of meetings during the summer last year and issued additional guidance on those topics based on the input from the panel. As we were issuing that guidance, we amended it to include the emphasis on significant judgement to coincide with the FASB and SEC interpretations.

We looked at the FASB’s recent FSP on fair value measurement in illiquid markets and concluded that it does not differ from the guidance in our literature and in the Panel document. There is some confusion, however, because the initial draft of the FSP contained a presumption that transactions in illiquid markets could be ignored unless there was evidence to show those transactions were not distressed. That presumption was removed from the final FSP.

So let me repeat, we think that the guidance in US GAAP and IFRSs is the same and we believe the emphasis on judgement is appropriate.

That said, to reduce any continuing fears, the exposure draft we shall be publishing soon on Fair Value Measurement will include the FASB FSP language.

- CONSOLIDATION AND DERECOGNITION - We accelerated our consolidation and derecognition projects, both dealing with off balance sheet activities, and on each we published exposure drafts that include enhanced disclosures about off balance sheet

- DISCLOSURES - We have amended and proposed amendments IFRS 7, dealing with disclosures about risk of financial instruments, and we introduced a three-level hierarchy for fair value measurement similar to the United States along with disclosures about the reliability of those measurements.

- FINANCIAL INSTRUMENTS - We are accelerating our project on financial instruments to replace IAS 39, and intend to publish a proposal on classification and measurement within six months followed by a proposal on hedge accounting.

I would like to talk a little bit about our accelerated financial instruments project.

Our project directly addresses the G20's call for standard-setters to take action by the year-end 'to reduce the complexity of accounting standards for financial instruments'.

At a very high level we are all in agreement about the objectives for the project. We need to reduce complexity, increase comparability and transparency, rethink impairment rules to recognise losses more promptly and provide a basis for convergence worldwide, in other words a level playing field.

Our six-month time frame is aggressive, but achievable if we attack the issues in an orderly way and sequentially.

We will start with classification and measurement alternatives. We understand the causes of complexity:

- We have 12 different measurement methods for financial instruments including three for impairment.

- We have 22+ ways of getting to one of the measurement methods based on a combination of criteria including type of instrument, its activity in the marketplace, management's intentions by designation, and management's intentions with various qualifying criteria.

We can reduce complexity if we reduce the measurement alternatives and provide a better rationale for the alternatives that remain. Our goal would be to get to two measurements.

Clearly, some instruments will be at fair value and others will not, but we have to decide how to make the cut.

Is it the characteristics of the instrument, its activity in the marketplace or management's intentions? Each of these alternatives can complement or conflict with each other, so we have to decide what trumps what, that is to say, what has primacy.

As part of the project, we will address the issue of transfers out of fair value. The consideration here will depend on how we draw the line to distinguish the fair value and non-fair value categories.

Impairment is clearly part of this project. We are trying to get to a single impairment method but first we have to sort out classification to determine if that is feasible. My inclination (me not other Board members) is that if the instrument was toxic from the start, that is to say, if it had highly volatile cash flows so that the investment was speculative in nature, the instrument should probably be at fair value. For plain vanilla, ordinary receivables, loans and investments with stable cash flow characteristics, a cost model seems appropriate, assuming that management is not trading the instrument, and impairment should be based on expected cash flows. But right now we include both extremes in the available-for-sale category and to some extent in loans and receivables, so we need first to sort out the classification of financial instruments and then try to get to a single impairment model.

As part of our evaluation of impairment we will consider developing an expected loss model to replace the current incurred loss model.

We are told that the incurred loss model provides too little too late. So we are exploring an expected loss model whereby provisions would be recognised for expected losses that have been identified on the basis of history and current expectations.

There are other issues here about going beyond expected losses and recording additional amounts today to provide a buffer for the future to promote financial stability. This issue is more about the objective of financial reporting and a question about providing useful information to users.

We have been and will continue to work with banking regulators through the Basel Accounting Committee to explore the expected loss model. We believe additional reserves beyond expected losses that might be required by regulators for capital purposes are more a regulatory issue than an accounting issue. However, we also will be exploring with the regulators what might be done to provide transparency around regulatory reserve requirements through a capital allocation

Concerns have been expressed about recognising gains on the reduction in the fair value of an entity's own debt from credit deterioration. We will consider whether we should limit the use of fair value accounting in this regard as part of this project.

The next step is hedge accounting and how to reduce complexity. We expect to issue a separate document on this subject following our proposal for the classification and measurement of financial instruments. Our objective is to reduce complexity and increase transparency of hedge accounting activities. But first we need to understand how hedge accounting would change if we introduced an expected loss methodology.

Our staff have developed various alternatives they are considering for presentation to the Board in the next few months. The Board, in turn, will be deciding on which alternatives to propose for exposure. And, of course, we are working with the FASB on this project. We have a joint meeting with the FASB in July and I expect that after that meeting we will be in a position to start moving towards the exposure draft phase.

Understandably, I have focused much of my remarks on the financial crisis. We live in unprecedented times and the IASB has demonstrated its commitment to respond in an urgent and responsible manner.

It seems natural to focus only on the difficult challenges facing us. The tasks before us are certainly daunting.

I also think that it worth reflecting on the bigger picture. In 2002, the European Union took the bold step of adopting IFRSs as the EU's set of accounting standards. As I mentioned at the start, that decision was the catalyst for the use of IFRSs worldwide.

The need for a global response to the credit crisis, a global problem, is evident and has been emphasised by world leaders. Because of the EU's decision, we are now in the position today of being able to provide a basis for a single set of financial reporting standards and to create a level playing field worldwide.

It is now up to us to work together to help restore the confidence that our financial markets desperately need.